BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FREDERICK AND CHARLOTTE DILLETT)

For Appellants: John Starr
Attorney at Law

For Respondent: Philip M. Farley
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Frederick and Charlotte Dillett for reassessment of jeopardy assessments of personal income tax in the amounts of $4,386.92 and $1,136 for the years 1981 and 1982, respectively.

The primary issue presented is whether respondent has properly reconstructed the amount of unreported income from illegal sales of narcotics which appellant Frederick Dillett received during the period at issue. We are also asked to determine whether Dillett's spouse is entitled to relief from the imposition of tax, if any, based upon such reconstruction pursuant to Revenue and Taxation Code section 18402.9, the so-called innocent spouse provision.

On March 22, 1982, a detective of the Glendale Police Department received information from a confidential informant (hereinafter "C.I.") indicating that appellant was selling cocaine. Under the direction and control of the police department, the C.I. made a recorded telephone call to appellant arranging for the purchase of one ounce of cocaine for $1,800. Appellant agreed to ship that cocaine by Federal Express, under bill number 437932176, on March 23, 1982. Thereafter, detectives followed appellant to a "Mail It Center" where he was observed placing a Federal Express envelope in the drop box. At that time, appellant was detained and a search warrant was obtained for the drop depository and appellants' residence. The subject envelope was recovered from the drop box and was found to contain one ounce of cocaine. Appellant was then arrested and served with the search warrant for his residence. That search produced the following items:

(1) Approximately .7 ounces of cocaine.

(2) Approximately 2.6 pounds of marijuana,

(3) Approximately 4.7 ounces of hashish.

(4) An "OHAUS" gram scale.

(5) Four Federal Express envelopes.

(6) Three bottles of cutting agent.

(7) $6,890 in cash.

(8) A cocaine freebasing kit.

(9) Miscellaneous narcotics paraphernalia,

(10) Pay and owe accounting sheets dated for part of 1981 and dated for 1982 until the day of appellant's arrest.

Based upon the above, appellant was charged with violation of section 11351 of the Health and Safety Code (Possession of Cocaine for Sale) and section 11359 of that same code (Possession of Marijuana for Sale). Appellant agreed to cooperate with the arresting authorities and described his activities. Appellant stated that he was involved in heavy use of cocaine and alcohol, but that he was not "dealing" cocaine, as such. Rather, he was purchasing cocaine in larger quantities in order to obtain it more cheaply, sharing the savings with his friends. Appellant stated that he would purchase cocaine for $2,200 per ounce, cut it 50 percent, thereby producing *one* and one-half *ounces,* and sell the resulting mix for $1,800 per ounce, thereby producing $500 of profit per ounce purchased. He also stated that he grew marijuana in his greenhouse for his own use. The police report indicated that appellant appeared to be a responsible, ambitious young man who had led a law-abiding life up until the time he became involved in the abuse of cocaine and alcohol in 1981, That report concluded that the abuse appeared to be a temporary situation, which appellant now regretted and for which he has made every effort to correct. On July 15, 1982, appellant entered a negotiated plea of guilty to a violation of section 11350 of the Health and Safety Code (Possession of Cocaine) and the original charges were dismissed.

Upon being notified of appellant's arrest, respondent determined that the circumstances indicated that coblection of personal income taxes for 1981 and 1982 would be jeopardized by delay. Accordingly, jeopardy assessments were issued. In issuing the jeopardy assessments, respondent relied upon. appellant's statements indicating that he had performed this transaction about 20 times from January. 1, 1981, through March 30, 1982, at the time of his arrest, thereby selling 30 ounces for $1,800 each or $54,000.[1/] Initially, the amount of legitimate income reported on the appellants' 1981 form 540 (i.e., $10,941) was added to this figure resulting in a net tax of $3,385.51 for 1981 and $97 for the period January 1, 1982, through March 23, 1982. However, based upon projections of appellant's pay and owe records noted above, respondent subsequently determined that total cocaine sales for 1981

1/ Pursuant to Revenue and Taxation Code section 17297.5, no deductions, including cost of goods sold, are allowed to any taxpayer for any income directly derived from illegal activities.

amounted to $90,406, while such sales for the period under review in 1982 amounted to $24,012.[2/] Accordingly, on September 30, 1983, respondent determined that appellant's taxable income for 1981 should be adjusted to $111,347[3/] to reflect this *later* determination and a supplementary jeopardy assessment was issued. In addition, on October 3, 1983, respondent determined that the 1982 assessment should be increased to $35,808 (gross cocaine sales of $24,012 plus taxable income of $11,796 per 1982 form 540) and a second supplementary jeopardy assessment was issued. While admitting that he received income from illegal sources, appellant filed a petition with respondent for reassessment contending that respondent's reconstruction of that income was not accurate.

The California Personal Income Tax Law requires a taxpayer to state specifically the items and amount of his gross income during the taxable year. Gross income includes all income from whatever source derived unless otherwise provided in the law. (Rev. & Tax. Code, § 17071.) Gross income includes gains derived from illegal activities, including the illegal sale of narcotics, which must be reported *on* the taxpayer's return. (United States v. Sullivan, 274 U.S. 259 [71 L.Ed. 1037] (1927); Farina v. McMahon, 2 Am.Fed.Tax R.2d 5918 (1958).) Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Treas. Reg. § 1.446-1(a)(4); former Cal, Admin. Code, tit. 18, reg. 17561, subd. (a)(4), repealer filed June 25) 1981 (Register 81, No. 26).) In the absence of such records, the taxing agency is authorized to compute a taxpayer's income by whatever method will, in its judgment, clearly reflect income.. (Rev. & Tax. Code, § 17561, subd. (b).) The existence of unreported income may be demonstrated by any practical method of proof that is available. (Davis v. United States, 226 F.2d 331 (6th Cir, 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) Mathematical exactness is

2/ Accordingly, the projection based upon appellant's pay and owe records superseded the projection based upon appellant's statements (i.e., $54,000).

3/ In both respondent's brief and the hearing officer's report, the $90,406 figure for gross cocaine sales was added to appellant's other taxable income for 1981 of $10,941 to arrive at respondent's total taxable income figure. However, as is apparent, the sum of the two figures should be $101,347 and not $111,347,

not required. (Harold E. Harbin, 40 T.C. 373, 377 (1963).) Furthermore, a reasonable-reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

In the instant appeal, respondent used the projection method to reconstruct appellant's income from the illegal sale of cocaine.[4/] In short, respondent projected a level of income over a period of time. Because of the difficulty in obtaining evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this sort. (See, e.g., Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964), affd. sub nom., Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966); Appeal of Burr MacFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) It has also been recognized, however, that a dilemma confronts the taxpayer whose income has been reconstructed. Since he bears the burden of proving that the reconstruction is erroneous (Breland v. United States, supra), the taxpayer is put in the position of having to prove a negative, i.e., that he did not receive the income attributed to him. In order to ensure that use of the projection method does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board have held that each assumption involved in-the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd.

4/ While respondent indicates that it based its reconstruction of appellant's income upon the projection method, as indicated infra, it relied heavily upon actual entries in appellant's pay and owe sheets to, at least, buttress that reconstruction. In effect, respondent used the specific item method to establish a base period from November 6 through December 6, 1981, and then used this amount to project sales before and after the base period. Since all of appellant's 1982 records were dated, respondent used actual recorded transactions, or the specific item method, in computing the 1982 assessment. (See generally Schmidt, Reconstruction of Income, 19 Tax L.R. 277, 281-283 (1964), and the cases cited therein for the propriety of using different methods of proof in concurrent and corrective periods.)

sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr MacFarland Lyons, supra.) Stated another way, there must be credible evidence in the record which, if accepted as true, would "induce a reasonable belief" that the amount of tax assessed against the taxpayer is due and owing. (United States v. Bonaguro, 294 F.Supp. 750, 753 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2nd Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be reversed or modified. (Appeal of Burr MacFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

In this appeal, the evidence relied upon by respondent in reconstructing appellant's income was derived from the results of the police investigation and statements made by appellant. Respondent determined that appellant had been in the business of selling cocaine and/or marijuana throughout 1981 and through 1982 until his arrest and that the pay and owe sheets seized at appellant's house at the time of his arrest indicate sales of $90,406 fot 1981 and $24,012 for 1982. Specifically, the actual pay and owe records- indicate that between November 6, 1981, and December 6, 1981, $42,389, or $1,412 per day, of business was recorded. Respondent determined that appellant sold an amount equal to one-third of the above per-day total from October 1, 1981, through November 5, 1981, or $14,129, and an amount equal to the above per-day total from December 7, I981, through December 31, 1981, or $33,888, Moreover, since all of appellant's 1982 records were dated, actual transactions of $24,012 was used by respondent to determine appellant's 1982 income from cocaine sales. Appellant admits that he was in the business of selling cocaine during the entire period at issue and that the subject pay and owe sheets document his drug sales activities, but contends that some of the entries on those sheets involve non-drug transactions. Accordingly, the only disagreement between the parties involves the significance of the entries made on the pay and owe sheets.

The sheets themselves make no distinction between the alleged drug and non-drug activities and appellant has offered no evidence to buttress his bare allegation. One critical fact is that during the summer. of 1981, there was no activity at all noted on the sheets. Appellant explained that this hiatus was due to the fact that his sole supplier was out of the country during this period thereby eliminating his drug sales activities completely. While appellant has adequately explained why

his drug sales activities were discontinued during this period of time, he has offered no explanation as to why his alleged non-drug activities were also discontinued during the same period. It seems highly unlikely to us that if the sheets documented non-drug activities, that these activities would, coincidentally, cease at this same time. Accordingly, we must find there is no basis for appellant's allegation that the subject sheets document non-drug activities in addition to drug activites. Based upon the record presented us, we have no choice but to sustain respondent's reconstruction of appellant's income during the period at issue. However, to the extent that respondent has miscalculated the tax effect of that income (see footnote 2/), the assessment for 1981 must be modified.

A second area of concern actually raised by respondent is whether appellant's wife, Charlotte, should be entitled to the protective provision.; of Revenue and Taxation Code section 18402.9, the so-called innocent spouse provision. Section 18402.9 provides, in relevant part, that in order to qualify for innocent spouse status and thereby relieve Charlotte from the instant assessment, it must be established that in signing the returns she did not know or have reason to know of the understatement caused by not reporting the 'income from drug sales and that she did not significantly benefit from such understatements. Appellants have presented no evidence upon which we could_ make such findings. Accordingly, we have no choice but to hold that Charlotte does not qualify for section 18402.9 treatment.

Based upon the foregoing, respondent's action must be modified in accordance with the opinion above.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of Frederick and Charlotte Dillett for reassessment of jeopardy assessments of personal income tax in the amounts of $4,386.92 and $1,136 for the years 1981 and 1982, respectively, be and the same is hereby modified in accordance with this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 5th day Of February, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

Ernest J.. Dronenburg, Jr., Chairman

William M. Bennett, Member

Richard Nevins, Member

Walter Harvey*, Member

, Member

*For Kenneth Cory, per Government Code section 7.9